

Pinduoduo (PDD US)

Strategy shift to agri-tech

- Strategic shift from sales and marketing to R&D in agri-tech could improve profitability
- Expect setbacks in 2Q22 results but recovery can resume in 3Q assuming relaxations of COVID-related measures
- Growth re-accelerated in 1Q22, driven by agricultural product despite a weakened economic backdrop
- Maintain **BUY** with a TP of US\$ 65

Company Report

June 1, 2022

Rating: **BUY**
 TP: US\$ 65

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Strategic shift from sales and marketing to R&D in agri-tech . The Company is shifting its priority from sales and marketing to R&D in agri-tech and infrastructure. In our view, increased controls over sales and marketing spending have led to improved profitability in recent quarters, even though lower sales and marketing expenses may imply less subsidies and discounts with potential impacts on user experience and stickiness. The Company seeks to strike a balance between growth and profitability.

Potential recovery in 3Q22. Despite a weakened economic backdrop, PDD's online marketplace service revenue jumped 29% YoY in 1Q22 vs. 19% YoY in 4Q21. Agricultural products have become a major growth driver amid ongoing investments and improved logistics services during the Chinese New Year. Looking forward, 2Q22 could be soft due to COVID-related downturn but sequential improvement can be expected starting from 3Q22, assuming lockdown and social distancing measures to relax in coming months.

Maintain BUY. We maintain our **BUY** rating with a DCF-based TP is US\$ 65. In our view, the market has been pricing in the lackluster 2Q22 performance for the e-commerce sector, while a potential sequential improvement in 3Q22 and improving profitability amid strategy shift to agri-tech could potentially drive share price performance in coming months.

Price	US\$ 50.3
Est. share price return	29.1%
Est. dividend yield	NA
Est. total return	29.1%
Last Rating & TP	BUY, US\$230
Previous Report Date	Feb 10, 2021

Source(s): Bloomberg, ABCI Securities estimates

Key Data

52Wk H/L (US\$)	143.1/23.2
Outstanding shares (mn)	5,057
Market cap (US\$ mn)	63,661
3-mth avg daily turnover (US\$ mn)	498
Major shareholder(s)	
Zheng Huang	27.9%

Source(s): Bloomberg, Company

Results and Valuation

FY end Dec 31	2020A	2021A	2022E	2023E
Revenue (RMB mn)	59,492	93,950	104,454	128,704
Chg (% YoY)	97.4	57.9	11.2	23.2
Net profit (RMB mn)	(7,180)	7,769	9,994	14,315
Chg (% YoY)	NA	NA	28.6	43.2
Core net profit*(RMB mn)	(2,966)	13,829	15,194	19,963
Chg (% YoY)	NA	NA	9.9	31.4
Earnings per ADS (RMB)	-6.0	5.4	7.0	10.1
Chg (% YoY)	NA	NA	29.2	43.2
Core earnings per ADS (RMB)	-2.5	9.7	10.7	14.0
Chg (% YoY)	NA	NA	10.3	31.4
Core P/E (x)	NA	34.6	31.4	23.9
P/S (x)	6.7	5.1	4.6	3.7
ROAE (%)	NA	11.5	12.1	14.4
ROAA (%)	NA	4.6	5.0	6.0

Note: 1ADR=4 ordinary shares

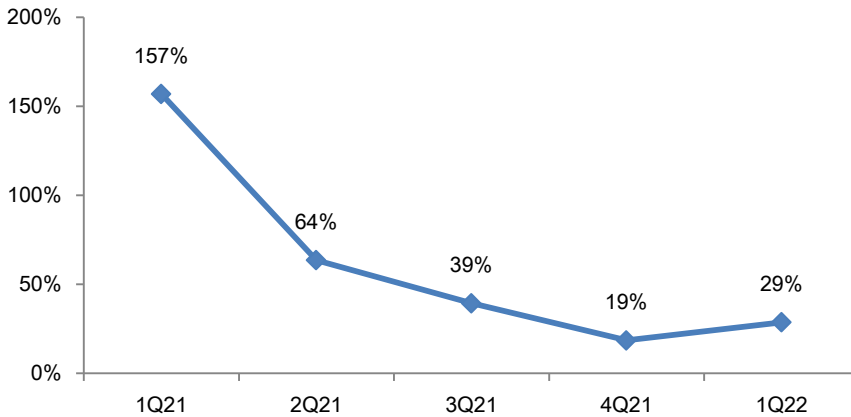
*Core net profit = Non-GAAP profits attributable to shareholders, which exclude share-based compensation and other non-operating items

Source (s): Bloomberg, ABCI Securities estimates

Recent business update and near-term outlook

Despite a weakened economic backdrop, PDD's online marketplace service revenue growth accelerated to 29% YoY in 1Q22 vs. 19% YoY in 4Q21. According to the management, the high demand of agricultural products in 1Q22 can be attributed to the strengthening of logistic services during the Chinese New Year period.

Exhibit 1: Online marketplace service revenue growth (YoY)



Source(s): Company

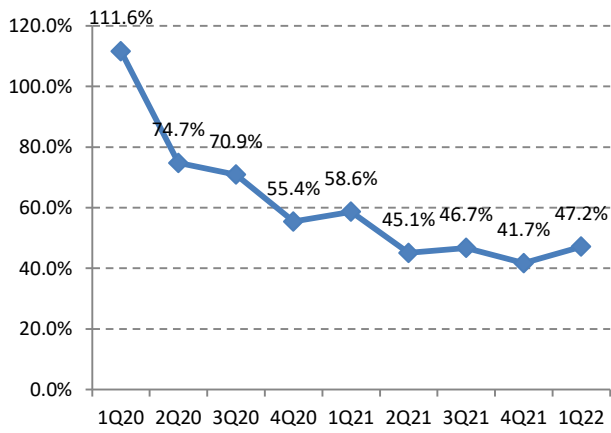
Overall, Pinduoduo's total revenue grew 7% YoY in 1Q22 vs. 3% YoY in 4Q21. Note that revenue contribution from merchant sales (1P) business dropped to 0.2% in 1Q22 vs. 23% in 1Q21. Excluding merchant sales (1P) in the calculation, Pinduoduo's ex-1P revenue growth was 39% YoY in 1Q22 vs. 28% YoY in the previous quarter.

In our view, the re-accelerating growth in 1Q22 could also be attributed to more effective use of sales and marketing expenses during the quarter. The Company has shifted its priority from sales and marketing to R&D in recent quarters by launching a RMB10bn initiative to facilitate advancement in agri-tech and infrastructure. As a result of the tightened expenses, marketing expenses/revenue ratio has been falling, driving up profitability. In 2Q21-1Q22, the Company achieved a positive core net profit. On the flip side, lower sales and marketing expenses imply reduced subsidies and discounts, which may affect user and revenue growth in the near term. In our view, it is important for the Company to increase effectiveness of sales and marketing campaigns.

Looking forward, we expect 2Q22 results to dip due to the COVID-related downturn in e-commerce industry given the logistics bottlenecks, lockdowns, and lower consumer sentiment. Nonetheless, we notice sales on e-commerce platforms seem to improve in May 2022 compared to previous month. Looking forward, we expect some recovery starting from 3Q22, assuming the COVID-related restrictive measures will relax.

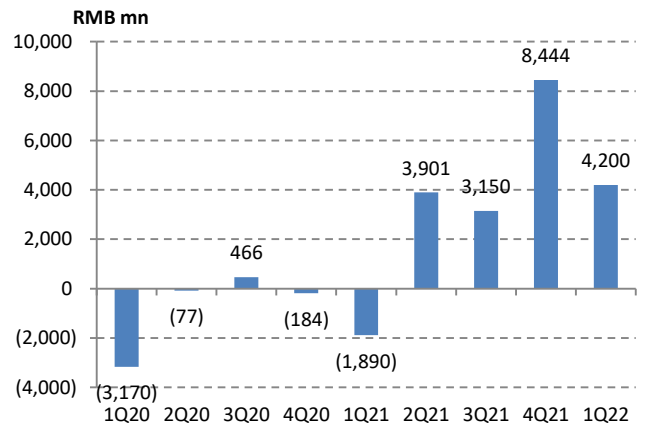


Exhibit 2: Sales and marketing expenses/revenue ratio



Source(s): Company

Exhibit 3: Positive core net profit in recent quarters



Source(s): Company



Financial outlook

We introduce 2022E and 2023E financial forecast. For 2021-23E, we expect GMV to grow at 17% CAGR to RMB 3.3tr by 2023E, on the back of 4% CAGR of annual active customer growth and 13% CAGR of annual spending per active customer. We factor in a slow user growth going ahead given the Company's high user base and intensified competition in lower-tier cities.

We expect revenue to increase at 17% CAGR in 2021-23E, in line with the GMV growth. Note that contribution from merchant sales business has dropped significantly since 3Q21 and we expect contribution to remain minimal going forward. After all, we believe the business was set up to fulfill transient increase in product demand that started in 4Q20.

Exhibit 4: Major assumptions

	2020	2021	2022E	2023E	21-23E CAGR
Annual active customer account (mn)	788	869	912	939	4%
GMV (RMB bn)	1,668	2,441	2,768	3,364	17%
Annual spending per active customer (RMB)	2,116	2,810	3,035	3,581	13%

Source(s): Company, ABCI Securities estimates

Exhibit 5: Revenue forecasts (RMB mn)

	2020	2021	2022E	2023E	21-23E CAGR
Online marketplace services	47,954	72,563	83,043	100,930	18%
Transaction services	5,787	14,140	21,211	27,574	40%
Merchant sales	5,751	7,246	200	200	NA
Total revenue	59,492	93,950	104,454	128,704	17%

Source(s): Company, ABCI Securities estimates

On the cost front, sales and marketing expenses has been the largest cost item due to the aggressive strategy on subsidies and promotion to drive growth. Since PDD shifted its priority to R&D in recent quarters, profitability has improved. Looking forward, we expect non-GAAP sales and marketing expenses/revenue ratio to fall from 46% in 2021 to 43% in 2023E on stringent expense control. Nonetheless, we expect R&D expenses/revenue ratio to increase from 7.1% in 2021 to 9.0% in 2023E on increased investments in the agricultural sector. Overall, we expect non-GAAP core net profit to grow at 20% CAGR to RMB 19.9bn by 2023E.



Exhibit 6: Non-GAAP cost trend (RMB mn)

	2020	2021	2022E	2023E
COGS	19,247	31,691	34,470	41,185
Sales and marketing expenses	40,101	43,190	45,960	55,343
General & admin expenses	540	748	731	901
R&D expenses	5,372	6,649	9,401	11,583
Total	65,260	82,278	90,561	109,012
% of revenue				
COGS	32.4%	33.7%	33.0%	32.0%
Sales and marketing expenses	67.4%	46.0%	44.0%	43.0%
General & admin expenses	0.9%	0.8%	0.7%	0.7%
R&D expenses	9.0%	7.1%	9.0%	9.0%
Total	109.7%	87.6%	86.7%	84.7%

Note: Excl. impacts of share-based compensation and other non-operating items
 Source(s): Company, ABCI Securities estimates



Valuation and TP

We maintain our **BUY** rating on the counter with a DCF-based TP is US\$ 65.

Exhibit 7: DCF sensitivity

	WACC					
		12.0%	13.0%	14.0%	15.0%	16.0%
Terminal growth	2.0%	72.9	65.9	60.0	55.1	50.9
	2.5%	76.5	68.7	62.2	56.8	52.2
	3.0%	81.0	72.1	64.8	58.8	53.9
	3.5%	86.6	76.2	67.9	61.2	55.7
	4.0%	93.7	81.3	71.7	64.1	57.9

Source (s): ABCI Securities estimates

*Assuming 16.5% cost of equity, 8% cost of debt, 25% tax rate, 25% long-term debt to capital ratio for the mid-point of WACC (14%).

In our view, the re-acceleration of revenue growth in 1Q22 has alleviated some concerns. In addition, we believe the market has been pricing in the lackluster 2Q22 performance for the e-commerce sector. Solid results in the next few quarters would help fortify confidence on the strategy shift to R&D.

Concerns on US delisting risks and potential divestment of strategic shareholders will remain in the near term; impacts of delisting in the US can be reduced if plans on HK or PRC listing is announced.

Exhibit 8: TP changes (US\$ per share)

Old	New	Methodology-old	Methodology new
230	65	DCF with 8.5% WACC	DCF with 14% WACC

Source(s): ABCI Securities estimates



Financial forecast

Consolidated income statement (2020A-2023E)

FY Ended Dec 31 (RMB mn)	2020A	2021A	2022E	2023E
Total revenue	59,492	93,950	104,454	128,704
Cost of sales	(19,279)	(31,718)	(34,511)	(41,231)
Gross profit	40,214	62,232	69,942	87,473
Sales and marketing	(41,195)	(44,802)	(47,382)	(56,901)
General and admin	(1,507)	(1,541)	(1,989)	(2,279)
R&D	(6,892)	(8,993)	(11,379)	(13,750)
Operating Profits	(9,380)	6,897	9,192	14,544
Interest income	2,455	3,062	3,500	3,500
Interest expenses	(757)	(1,231)	(900)	(900)
Fx gain	225	72	0	0
Others, net	193	656	500	500
Share of results of investee	84	247	200	250
PBT	(7,180)	9,702	12,492	17,894
Tax	0	(1,934)	(2,498)	(3,579)
PAT	(7,180)	7,769	9,994	14,315
Minority interests	0	0	0	0
Profits attributable to shareholders	(7,180)	7,769	9,994	14,315
Share-based compensation	3,613	4,775	4,700	5,148
Other non-core items	602	1,286	500	500
Non-GAAP profits attributable to shareholders	(2,966)	13,829	15,194	19,963
Basic earnings per ADS (RMB)	(6.02)	6.20	7.94	11.37
Diluted earnings per ADS (RMB)	(6.02)	5.44	7.03	10.07
Diluted non-GAAP earnings per ADS (RMB)	(2.49)	9.68	10.68	14.04
Growth				
Total revenue (%)	97.4	57.9	11.2	23.2
Gross Profit (%)	68.9	54.8	12.4	25.1
Operating Profit (%)	NA	NA	33.3	58.2
Net profit (%)	NA	NA	28.6	43.2
Non-GAAP net profit (%)	NA	NA	9.9	31.4
Operating performance				
Operating margin (%)	(15.8)	7.3	8.8	11.3
Net margin (%)	(12.1)	8.3	9.6	11.1
Core net margin (%)	(5.0)	14.7	14.5	15.5
ROAE (%)	NA	11.5	12.1	14.4
ROAA (%)	NA	4.6	5.1	6.2

Note. Individual items may not sum to total due to rounding
Source(s): the Group, ABCI Securities estimates



Consolidated balance sheet (2020A-2023E)

As of Dec 31 (RMB mn)	2020A	2021A	2022E	2023E
Fixed assets	203	2,203	3,903	5,903
Intangible assets	1,277	701	736	773
Other non-current assets	7,905	17,396	18,219	19,083
Total non-current assets	9,385	20,300	22,858	25,759
Cash & equivalents	22,421	6,427	30,766	58,762
Restricted cash	52,422	59,617	65,579	72,137
Short-term investments	64,551	86,517	87,517	92,517
Account receivables	730	674	707	743
Other current assets	9,400	7,675	7,887	8,110
Total current assets	149,523	160,909	192,457	232,269
Total assets	158,908	181,210	215,315	258,028
Payable to merchants	53,834	62,510	73,999	91,914
Merchant deposit	10,926	13,578	16,758	20,112
Borrowings and notes	1,866	0	1,000	2,000
Other current liabilities	17,255	17,642	17,820	18,007
Total current liabilities	83,882	93,730	109,577	132,032
Convertible bonds	14,433	11,789	15,326	16,092
Other non-current liabilities	418	576	603	632
Total non-current liabilities	14,851	12,365	15,929	16,724
Total liabilities	98,732	106,095	125,506	148,756
Equity attributable to shareholders	60,176	75,115	89,808	109,271
Non-controlling interests	-	-	-	-
Total equity	60,176	75,115	89,808	109,271

Note. Individual items may not sum to total due to rounding
Individual items may vary from reported figures due to rounding /definition differences
Source(s): the Group, ABCI Securities estimates

Consolidated cash flows (2020A-2023E)

As of Dec 31 (RMB mn)	2020A	2021A	2022E	2023E
Net income	(7,180)	7,769	9,994	14,315
Depreciation and amortization	651	1,495	1,800	2,000
Other non-cash adjustments	3,676	5,957	4,700	5,148
Change in working capital	31,049	13,562	11,346	14,533
Operating cash flow	28,196	28,783	27,839	35,996
Acquisition of fixed asset	(43)	(3,287)	(3,500)	(4,000)
Net purchase of investments	(38,077)	(32,720)	(1,000)	(5,000)
Other investment cash flow	(237)	445	-	-
Investing cash flow	(38,357)	(35,562)	(4,500)	(9,000)
Financing cash flow	51,798	(1,875)	1,000	1,000
Fx effect	(140)	(145)	-	-
Net cash flow	41,497	(8,799)	24,339	27,996

Note. Individual items may not sum to total due to rounding
Individual items may vary from reported figures due to rounding /definition differences
Source(s): the Group, ABCI Securities estimates

Risk factors

Tightened regulatory environment

The government has implemented various measures in recent months to tighten regulatory environment. The State Administration for Market Regulation of the People's Republic of China (the "SAMR") has launched an anti-monopoly investigation on selected e-commerce platforms, imposing fines and demanding business restructuring of these platforms.

Market competition

The ecommerce industry is highly competitive, with companies contending on commission rate, promotion discount, brand advertising, technological investment, and more.

Slowdown in ecommerce consumption

As the industry is dependent on consumer spending, any significant slowdown of consumption in China would hamper the Company's performance. In the long term, we believe consumption growth in domestic market would converge with income growth, which is usually in line with GDP growth.

Non-GAAP financials

Ecommerce platforms generally disclosed the non-GAAP financial metrics, such as the non-GAAP net profit, to supplement its GAAP financial measures. Historically, there were differences between its GAAP net profit and non-GAAP net profit due to inclusion of items such as share-based compensation and other non-core items in the former.

Among these items, share-based compensation expense is related to various factors including price movement of ordinary shares, expected volatility, risk-free interest rate, etc.

While investors tend to exclude these items when performing analysis given their non-cash nature, we believe these non-GAAP financial measures should only serve as references.

Convertible bonds

In September 2019, the Company issued US\$1bn principal amount 0.00% convertible senior notes (2024 Notes). It will mature on October 1, 2024 with a conversion rate of US\$42.61 per ADS. In addition, in November 2020, the Company issued US\$2bn principal amount 0.00% convertible senior notes (2025 Notes). The Notes will mature on December 1, 2025 with a conversion rate of US\$190.63 per ADS.



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Definition of equity rating

Rating	Definition
Buy	Stock return rate \geq Market return rate (\sim -10%)
Hold	- Market return rate (\sim -10%) \leq Stock return rate $<$ Market return rate (\sim +10%)
Sell	Stock return $<$ - Market return (\sim -10%)

Notes: Stock return rate: expected percentage change of share price plus gross dividend yield over the next 12 months
Market return rate: average market return rate since 2009 (HSI total return index 2009-21 averaged at 9.2%)

Time horizon of share price target: 12-month

Stock rating, however, may vary from the stated framework due to factors including but not limited to: corporate governance, market capitalization, historical price volatility relative to corresponding benchmark index, average daily turnover of the stock relative to market capitalization of the stock, competitive advantages in corresponding industry, etc.

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